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Irresponsible Lending? A Case Study of a U.K. Credit Industry Reform Initiative

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ABSTRACT. There are major concerns about the level of personal borrowing, particularly sourced from credit cards. This paper charts the progress of an initiative to create a Responsible Lending Index (RLI) for the credit industry. The RLI proposed to voluntarily benchmark lending standards and promote best practice within the credit industry by involving suppliers of credit, customer representatives and regulators. However, despite initial support from some banks, consumer bodies and the Chair of the Treasury Select Committee, it failed to gain sufficient support from financial institutions in its original format. The primary reasons for this were related to the complexity of building such a robust index and the banks trade body's fear of exposing its members to public scrutiny. A revised alternative, the Responsible Lending Initiative, was proposed which took into account these concerns. However, the Association of Payment Clearing Service (APACS), the trade body of the credit industry, then effectively destroyed the proposal. This article describes an attempt to address the challenges in the credit card industry with the initiation of the RLI, reflected in stakeholder discourse and in the context of a wider concern expressed by the involved stakeholders in terms of the need for greater responsibility in the banking industry's lending practices.

KEY WORDS: Banking, Borrowing, Credit, Ethics, Lending, Responsibility, Stakeholders

List of Abbreviations: APACS: Association of Payment Clearing Service; BBA: British Bankers Association; DTI: Department of Trade and Industry; FSA: Financial Services Authority; IVA: Individual Voluntary Arrangement; OFT: Office of Fair Trading; RLI: Responsible Lending Index; BCSB: Banking Code Standards Board

Introduction

The credit industry over the last 2 years has received considerable adverse media coverage (Fletcher,

2006) for allowing an expansion of debt. Particular individual tragic outcomes of suicide have been blamed on irresponsible lending practices (BBC, 2005; Ronson, 2005). In response, a self-regulation system was proposed to the leading banks who own the credit cards. The key features of the proposal was the creation of a voluntary benchmark—a Responsible Lending Index (RLI), which would set standards and promote best practice in credit lending. A defining factor of the index was its governance, which was grounded in stakeholder involvement, embracing not just the suppliers of credit—the banks—but also the consumer movement, the voluntary sector through the credit advisory services, as well as the government with the active interest of the Chair of the Treasury Select Committee.

Stakeholder engagement involves a relationship built on communication, consultation, dialogue and partnerships with stakeholders (Heymans, 2006). It aims to increase and improve the quality of involvement of different stakeholders' interests in certain governance processes (ODPM, 2005). The quality of engagement could be understood in terms of the opportunity, which stakeholders have to provide substantive input, as well as in terms of satisfaction with the outcomes of the engagement process.

Since stakeholder engagement was first outlined by Freeman in 1984, it has attracted considerable interest both as an attractive idea of participation and in its capacity to develop into a problematic concept like 'stakeholder democracy', which implies equality in the right to participate. As Matten and Crane identify:

The basic proposition—that stakeholders participate in processes of organizing, decision-making, and governance in corporations—is for many people an alluring prospect. It chimes well with current demands for

greater corporate accountability and offers a compelling evaluative framework for assessing corporate responsibilities to society. However, in an age of intensified shareholder capitalism and increasing complex global market systems, it can also appear to be little more than a hopelessly idealistic vision (Matten and Crane, 2005, p. 6).

In particular, they pose the managerial question of how a corporation could realistically balance the competing claims of disparate stakeholders in an organised framework of corporate governance. This article describes an attempt to address this challenging balance in the credit card industry with the initiation of the RLI, and analyses the context of its unsuccessful launch. This outcome, the paper will argue, leaves the concept of stakeholder participation in the bank industry in the realm of idealism.

This article has the following structure:

- history and context of credit lending in the U.K.—the immediate context (problem-based approach);
- description of the case—RLI concept, followed by its initiative year-long story and the involvement of various stakeholders;
- case reflections in stakeholder discourse, outlining the value and failure of the RLI; and
- discussion on the directions for development of the credit industry.

The analysis and conclusions focus on understanding the potential and shortcomings of the RLI in its attempt to respond to the credit industry issue of defining measurable standards.

Methods issues and academic involvement

This case study is based on the observation of the evolving RLI initiative, an idea grounded in the practice of the banking industry and from a perspective of its potential for reform and regulation. This practice-derived initiative finds its reflection in stakeholder discourse. This was conceptually the point of origin for initiating the RLI by its creator, as well as the concept which links the current credit industry in the U.K. with the responsibility, which the banking industry has to its customers.

The methodology is derived from the perspective of Lawrence (1992) on problem-oriented research. First, a significant emerging problem is selected which allows to link the macro and micro levels of analysis, respectively, the current development of the credit industry in the U.K. in terms of its reform and regulation of practices, and the specific RLI mechanism which addressed this. Then, key parameters are examined (credit industry practices, stakeholder relevance, the image and behaviour of banks) and related to relevant theories (stakeholder framework, corporate responsiveness and tragedy of the commons). The analysis is conducted in light of understanding the potential and shortcomings of the RLI in its attempt to respond to the credit industry issue of defining measurable standards. The problem-oriented approach is reflected in the critique and conclusions, drawing on the RLI case for lessons relevant to the stakeholder discourse in terms of addressing the current practice in the credit industry, rather than embedding the RLI in a theory-building stakeholder context.

The second-named author was invited to participate in the RLI initiative by its creator, Steve Round (then CEO of Hurlstons), a management consultant specialising in the credit card industry. Through attendance observation, the first-named author closely followed the progress made by Round in negotiating support for the initiative with various stakeholders within the credit industry. Primary data was obtained and the authors attended a number of meetings with Steve Round, where observations were made on the attitude of stakeholders representing differing opinions. As identified by Fry (1973), direct observation has some challenges that the researcher needs to address—the large amount of time invested in observation studies, the decision on whether to be a hidden or visible observer and the possible loss of objectivity. When attending meetings, the observer was introduced as a member of the RLI team and as a researcher. The impact of having a silent observer present hopefully has been minimal, as both Round and the negotiating party were professionals and would have had no reason to withhold comments due to the observer's presence.

Vidich (1955) has looked at the issue of observer objectivity and identified two main concerns. The researcher may influence the character of data collected or interpret the data subjectively, both of

which could lead to distortion. Although viewed from the stakeholder viewpoint as belonging to the RLI team, the observer supported by the second-named author maintained a distance to the proposal. A range of data sources were used in the literature review and have been drawn upon during the analysis.

The growth of the credit industry

In June 2005 the total U.K. consumer debt amounted to £1.1 trillion and is growing by £1 million every 4 min (Talbot, 2006). Less than a century ago the credit industry barely existed, so what has caused this rapid expansion? The consumer boom following World War I resulted in a shift from the earlier mentality of saving up for a product and then purchasing it for cash to “buy now pay later” (Olney, 1989, 1991). Following the Second World War a period of growth fuelled the credit industry. After years of rationing, consumers were eager to get hold of goods instantaneously. Arrangements for payment at a later date were convenient for both buyers and producers. Shay (1956) classified credit available to post-war U.S. consumers into two categories: cash lending and instalment sales financing. These were typically available from commercial banks, sales and personal finance companies and credit unions. Allison et al. (2003) found a similar post-war trend in the U.K., which was also followed by the growth of hire purchase and credit-based mail ordering.

In 1958, the Bank of America issued the first all-purpose credit card, which evolved into Visa and in 1966 the MasterCard was created. Barclays launched the first credit card in Britain, the Barclaycard, in 1966. During the 1950s through to the 1970s U.K. Governmental control over credit lending was tight. Since the deregulation of the U.K. credit industry in the early 1980s, both supply and demand have transformed and expanded significantly (Stein, 2004). The total number of credit and charge cards in issue by banks in the U.K. has grown from 6,410,000 in 1975 to 71,887,000 cards in year ending 2004 (APACS, 2006). The leading credit card issuers in the U.K. include Barclays, Lloyds TSB, Royal Bank of Scotland, HSBC, HBOS and MBNA (Europe). In addition to traditional high

street banks, the credit card industry has seen a rise of new entrants from international credit issuers, such as Capital One. Since the 1990s internet-based lenders have also competed for their market share. Some established firms have set up a new branch to cater for the internet market, such as Prudential's venture Egg plc. Other startups such as EasyMoney are purely internet-based or use various channels of offering consumers credit through in-store finance options, buy-now-pay-later schemes, catalogue sales and store cards.

Other stakeholders—suppliers and customers

The suppliers consist of companies who provide credit issuers with technology-based solutions such as web software, security services, enterprise resource planning, customer relationship management software and the physical materials suppliers (stationery). The credit industry caters for both corporate and private customers, but this paper focuses on the latter in the U.K. only. Since the early 1990s low unemployment, reasonably stable inflation and base rates, and rising house prices in the U.K. have increased consumer confidence. Consumer spending has followed this period of economic stability unchecked by any controls. Ironfield-Smith et al. (2005) have outlined the economic issues facing U.K. consumers: the risk of increasing interest rates affecting those who have considerable loans and mortgages to pay off; the slowdown of the housing market impacting on consumer confidence; the increasing U.K. current budget deficit which may result in tax rises; and the large U.S. current account deficit, which if not curbed, may lead to international economic instability. Since November 2003 the Bank of England has consistently raised interest rates from 3.50% to a peak of 4.75%, increasing to 5% in December 2006. Coupled with rising petrol and fuel prices, this has led to U.K. consumers tightening their belts (Moore, 2005).

Knight (2005) noted that a record 26,000 property repossession orders were issued in the first three months of 2005. Figures from the Department of Trade and Industry (DTI, 2006) show the number of bankruptcies for the past 12 months total 60,102. This exceeds the total of 43,425 bankruptcies for the

previous twelve months by 38.4%. The increase in the number of people setting up individual voluntary arrangements (IVAs) with their creditors was up 95% on the previous period. This may be partly due to changes in bankruptcy legislation and the rise of debt intermediaries who advertise their services for a fee to create an IVA. However, there seems to be a clear underlying upward trend.

Technological advancements are particularly crucial to the credit industry. Figures from the Association for Payment Clearing Services (APACS, 2006) show that credit and debit card fraud totalled £504.8 million in 2004. On March 8th 2005 BBC News reported that card fraud over the internet, phone and mail order, amounts to £150.8 million a year in the U.K. 'Skimming', where a card's magnetic strip is electronically copied, costs U.K. card-holders over £100 million a year. APACS estimate that since the introduction of chip and PIN, debit and credit card fraud has fallen by 13%, now totalling £33 million. As security becomes increasingly tight due to advances in technology fraudsters are targeting the weakest link in the chain – the human aspect. Educating card holders about keeping their pin number secret will be vital in the combat against crime. The response by lenders to card fraud will increasingly be of interest to consumers.

The 1971 Crowther Committee concluded that users of consumer credit should be "treated as adults, who are fully capable of managing their own financial affairs, and not to restrict their freedom of access to it in order to protect the relatively small minority who get into difficulties" (Lord Crowther, 1971, p. 153). The subsequent Consumer Credit Act was introduced in 1974 and grounded in this philosophy remained un-reviewed until the new millennium. A new consumer credit act of 2005 took into account the new ways of borrowing, for example, the growth of credit cards, and incorporated the banking code developed by the banking code standards board. However, there is little transparency on the code's operation, for example, why the code is published, and there is no external scrutiny, which would allow a consumer to understand whether their lender is embracing the code or just maintaining minimal compliance.

The credit industry has been traditionally self-regulated, monitored by the Financial Services Authority (FSA). However, the increasing dissatis-

faction of consumers about lending practices, the number of people considered to be struggling with debt repayments and unfavourable media attention (Fletcher, 2006) over debt-related suicides, such as that of Richard Cullen (Ronson, 2005), has led the Government, consumer bodies and the industry to review this situation. Ironfield-Smith et al. (2005) establish that there is public support for governmental or financial industry regulation to prevent people from getting into unmanageable debt situations. The trend is for consumer groups and media coverage to drive politicians to act.

Allison et al. (2003) show that the importance of Ando and Modigliani's (1963) *Life Cycle Hypothesis*, which models the average propensity to consume over the lifetime of an individual, is that the demographic formation of the population will determine the demand for credit in a given country. However, access to credit and the ability to repay it depends more on an individual's age and socio-economic group than the aggregate demand for credit within an economy. Many lenders use demographic and lifestyle information, such as CA-CI's Acorn and Experian's Mosaic classifications, to target potential customers (Stevens, 2004). This has led to people being given far more unsecured credit than they can afford to repay, such as 100% of their salary and credit card limits that have moved the product on from being a short-term financial purchasing instrument into a source of long-term debt.

The changes in the structure of society have also given rise to new groups of borrowers. The breakdown of the nuclear family, resulting in single-person households, single parents and independent females with financial responsibilities living in an increasingly expensive country has led to the use of credit as an additional income. Tondeur notes that groups within lower income brackets are more likely to need to borrow due to existing problems and could experience severe problems should something go wrong because they often have fewer assets to fall back on (Talbot, 2006). This is particularly visible in the younger generations, from late teens to 30s, who are subjected to high levels of debt from a young age (Hurlston, 2005). The removal of university grants exposes students to find ways of funding themselves. According to NatWest (2005) an average graduate has £12,640 debt upon graduation.

Credit lending therefore is composed of complex interwoven groups far beyond a simple supplier and customer involvement. Customers who get into trouble have in effect 'proxy supporters' in the form of the various credit advice services supplied by voluntary organisations. Consequently, there is an interest from government beyond simple market regulation, with concerns about consumer levels of debt and confidence in the economy as well as a wider responsibility to its citizens.

Shortcomings in the banking system—the business case for responsible lending

The U.K. banking industry is well established and heavily regulated. Currently banks do not exploit the opportunity to impress customers by achieving over and above the legally required levels of service, partly because they do not see a competitive advantage in this but also due to the longstanding integrity and responsibility in banking (Cowton, 2002; Green, 1989; Hutchings, 2005). However, through implementing socially responsible lending and pursuing brand differentiation, a lender could gain sustainable competitive advantage. As Cowton (2002) identifies, the Co-operative Bank for example has marketed extensively its socially responsible banking activities and attracted new customers by this approach. Informed customers are less likely to feel post-purchase dissonance or that they have been swindled. A sense of pride in working for an employer that the public perceive as responsible it is suggested increases employee motivation levels (Pryce, 2002). Motivated staff communicate better with customers, have a positive attitude, go the extra mile and ultimately sell more. Consequently banks that adopt best practice would be likely to experience increased profits.

The industry is often portrayed by the media as malicious and hungry for profits at any expense to the consumer (Cowton, 2002; Green, 1989; Parker, 2005). A report by uSwitch.com (2006) found that 88% of successful credit card applicants were not requested to show any proof of their income. 95% of card holders had not been asked for evidence of their monthly outgoings when applying for credit. The report also found that details given by applicants were not verified in nine out of 10 applications. All

of this can leave the lender with an unclear picture of the customers' ability to service debt. This has resulted in lenders issuing credit limits which are far beyond the cardholders' annual earnings or affordability, which has in turn resulted in a drastic increase in bad debt being written off since 2000 (Cattermole, 2004). Unless banks take measures to address this, the situation is likely to become worse.

The classical assumption on protecting consumers argues that efficient markets are much more effective than formal regulations (Stigler, 1971). However Sir Cullum McCarthy (2004), Chairman of the FSA, argues that retail financial services are far from efficient. There is market failure due to "absence of information; the lack of financial literacy by buyers; information asymmetry between provider and purchaser; the market is characterised by credence goods—where the benefit can only be observed after the passage of time, if at all—and principal/agent problems" (McCarthy, 2004, p.22). As this appears to be so in retail financial services, there is a case for taking action and introducing statutory regulation—a theme that has been explored a number of times by the Treasury Select Committee.

The push from the Government and media towards an increasingly regulated industry and the pull of increased profits through adopting best practice shows that there is an opportunity for self-regulation to be developed further. There are already several vehicles for raising the standards within the credit industry at present. Most lenders are affiliated to trade associations such as the Association for Payment Clearing Services (APACS) and the British Banker's Association (BBA) and follow their voluntary codes of conduct. However not all lenders, such as those targeting the financially deprived with high profits in mind, are keen to pursue responsible lending practices. Thus, formal legislation as opposed to self-regulation can be argued to be more desirable (Cowton, 2002).

All lenders must comply with relevant Government initiatives, such as the expected amendments to the Consumer Credit Act. Any new legislation or regulation has to be brought in at industry level and the industry will generally argue for the lowest common denominator. Such initiatives can only move as fast as the slowest members in the industry, which may have reasons to delay regulation or to cover up bad practices. It can therefore be argued

that neither existing industry self-regulation nor governmental legislation give sufficient opportunity for companies to differentiate their brand. Was there an alternative, which would both satisfy the concerns over irresponsible lending and reward banks by giving them a competitive advantage?

The Responsible Lending Index (RLI)

To resolve this matter, the idea for the Responsible Lending Index (RLI) was generated as a proposal for a voluntary index for the credit industry which would allow lenders to measure themselves according to the degree of responsibility in their corporate processes. The measures of responsibility were grounded in the outcomes of a consultation process with key stakeholders from the industry, consumer groups, money advice organisations and the Government.

Round's background was in the credit industry and he had represented the banking sector in front of the media when soaring debt became an issue in 2000. His observation on the banks focused on their 'bland response' to the question on the criteria by which they conducted their lending practices. A culture of 'arrogance and secrecy' prevailed, which, he believed, did not serve the banks' interests and contrasted against the good lending practices of some banks that were left under-promoted. The focus on 'responsible lending' was derived from the European Directive for homogenisation. In October 2004 the Commission adopted an amended proposal for the Directive for the regulation of consumer credit. The European Parliament under the consumer credit directive conducted responsible lending tests within a philosophy that 'credit = debt = bad'¹.

Round's marketing background can be argued to have influenced the strategy behind the RLI, which was in essence a win-win marketing approach. The first was to promote the responsible practices of some banks, giving them visibility to the public. The RLI would give lenders a chance to stand out from the crowd, achieve over and above the minimum standards and raise the bar without legislation. Lenders would be able to promote their rating in public affairs communications and receive positive media attention, developing their own reputational

advantage. This would be reflected in customer choices and result in greater profitability to the lender. In addition to this proactive stance, the approach was also defined in preventive terms, where the RLI promoted industry reform to circumvent regulation. Round was concerned that unless the banks adopted a proactive stance to responsible lending which engaged stakeholders in a process of transparent practice of credit management, the drive for homogenisation would impose a regulation based on such a dichotomous philosophy. Such measures would be detrimental to the credit industry and its contingent market efficiency.

The RLI concept hoped to achieve a commonly accepted picture of what responsible lending should look like. This concept is illustrated in Figure 1. The broadest definition does not allow sufficient distinction between responsible and irresponsible practices. Likewise, it is impossible to ever define a single point of responsibility without narrowing the concept too much, and in doing so alienating many stakeholders over issues that cannot be agreed on. The solution is therefore likely to lie within the middle ground.

Deciding what to measure

The RLI aimed to define measurable standards based on protocols, which would be accepted and adopted by banks. For example, marketing and solicitation, acquisition of customers, account maintenance and processing, and dealing with delinquency are representative of the types of issues which would be assessed by the RLI. Within these areas standard processes would be identified for every aspect of business. Each process would then be weighted according to its relative importance in terms of

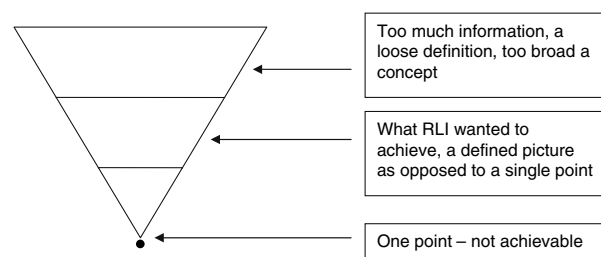


Figure 1. Defining the concept of responsible lending.

Irresponsible Lending

responsible lending. Ultimately the RLI would produce ratings similar to those to Moody's or the Fitch ratings, based on which bank policies would be adopted and implemented.

How to measure a process

The RLI would weigh, value and audit processes, which could be used as benchmarks for the industry. Defining the processes to be considered when rating lenders is best illustrated by a basic example.

Say delinquency has occurred. The lender may respond by

1. Sending a pleasant letter asking is there a problem and offering support.
2. Sending a threatening letter.
3. Sending a threatening letter and charging a fee of £25.
4. Involving the debt collector at this stage.

Each stakeholder group would decide in isolation how to rank the above responses from most desired practice to least desired practice. The responses would vary depending on which stakeholder group is ranking the process. For example, a consumer body representing the needs of consumers may attach most value to a lenient approach, such as a pleasant letter. On the other hand, a bank's objective is to maximise profits and they may view a fee as a crucial deterrent to late payments. However, in general the responses from different stakeholder groups should be similar enough to be used in statistical modelling.

Each identified process would be modelled and the responses ranked by each stakeholder group in the same way. The results for all processes, as ranked by stakeholders, would then be collated and each process weighted according to its relevance on a scale from one to 10, where 10 is significant and one non-significant. For example, processes for tackling delinquency could have a weight of eight. Other processes, such as the font size chosen for displaying information in the summary box on a statement may be weighted much closer to one.

Each process would be weighed in this manner, although inevitably the weight attached to some processes would be totally disputed. For example,

automatically increasing a credit limit may be seen as irresponsible by debt advisor groups, whereas a bank may consider this a way of rewarding customers and not a significant cause of debt problems. Out of 100 processes, hopefully stakeholders would be broadly in agreement about 90 of the processes but with the remaining 10 there would likely be larger differences in opinion. Therefore, to reach an agreement, an independently chaired debate would be necessary.

Transparency

The transparency of the real cost of credit card debt is at the heart of the process. As a result of the mortgage miss-selling crisis of the 1980s, mortgage lenders are now required to now produce an exact table of the real money cost of borrowing to new customers. This is not a practice applied for credit cards although recently some lenders have responded to the demands for transparency by showing what the cost of borrowing for that month is when the minimum amount is paid off. The industry is instead dominated by headline APR percentage rates, where for example, a rate of 9.5% could in reality be more expensive than a rate of 15.5%, depending on whether the outstanding credit balance is calculated on a daily, weekly, end of period or continuous compounding basis. This shows that the needed transparency which would allow comparison between credit products, is absent in the industry, as is consequently the consumers' understanding of the processes and input variables involved in the calculations, except for those who are highly literate in financial issues.

For the RLI to be robust and credible, it would require an independent observer throughout all stages and would have to be supported by the money advice and consumer organisations. The purpose of having an independent observer as Chair of a management group comprising representatives of Financial Institutions and Consumer Organisations would be to ensure the rigour and integrity of the audit. The observer would not actually take part in completing the audit on those companies signing up to the RLI (i.e. members). Their role would be to ensure that the processes looked at and the benchmarks set were sound and represented all stakeholder requirements satisfactorily. For the RLI to remain relevant, the bar

would need to be constantly raised and revised as developments in the environment took place. Here, again the independent observer would ensure evaluation and accommodation of changes without biases to any particular stakeholder group.

Analysis and critique of the proposed RLI—stakeholders' perspectives

Recognising that different stakeholders—banks, Consumer Groups and Government—would have different motivations for supporting the RLI, a series of potential issues arise. The authors have reflected on these issues in the following section.

If the RLI were implemented, the benefits for the banking stakeholders would be measured against the economic cost of transactions. This is the cost of making an economic exchange, i.e. the time, effort and resources required for a company to supply a customer with credit or for a customer to select and apply for credit. The first question that the proposed RLI had to answer for the lenders was whether the benefits of implementing responsible lending practices outweighed the foregone profits from not targeting vulnerable customers or applying high default fees. Late payments earn banks more than £1 billion a year (Treanor, 2006) and interest on overdrafts amounts to £3 billion a year (Levene, 2006). The transaction costs for banks would include the cost of implementing the necessary processes to comply with the RLI standards, acquiring accreditation (to be recognised as a responsible lender) and marketing that status.

Banks would also have to calculate the opportunity cost of investing the time, money and effort in another project instead. The difficulty lies with quantifying these transaction costs, as all calculations would be based on estimates of future exchanges between lenders and borrowers, which cannot be known until a standard is implemented. The transaction costs for the customer consist of the increased time spent searching and evaluating alternatives as the amount of information increases (opportunity cost of time), and the inconvenience factor as documentation and information required to be provided in order to receive credit increases.

At the time of its launch, the RLI had to also satisfy other important stakeholders, like the gov-

ernment, which was being pressured by consumer groups and by the media to regulate the credit industry. While all governments are concerned about the impact of borrowing on the wider economy, for a Labour government in particular there are also issues of social stratification (Toynbee, 2004). Matsuyama (2000) has argued that the distribution of wealth within a society in one period of time “affects the supply and demand for credit, which in turn affects the distribution of wealth in the following period” (p. 743). The author also observes that in a steady state of economy where the population is polarised into the rich and the poor, the household an individual is born into tends to determine their level of lifetime wealth. A perspective adopted by consumer groups is that the poor are in fact being kept in poverty by unattractive credit terms. Rahman (2005) has estimated that Britain's poor pay up to £500 million a year in excessive interest charges. Rahman also alleges that irresponsible lending practices keep the poor in debt. As the mainstream lending market is closed to them, they can face interest rates of 150% and upwards. Opposition to this opinion is led by those lenders who argue that access to credit, even with high charges, is better than no access.

Since the introduction of unsecured credit into the consumer market, those in the lower brackets of society have been able to purchase goods and services that may have been unobtainable without credit arrangements. They have also had the opportunity to improve their status in society in the long run. For example, if a low skilled worker was made redundant, but had access to credit through overdraft and credit card arrangements, they could finance further education and hence improve their employability and level of expected future wages. This would allow the poor to break free from their “poverty trap” by using unsecured credit. If responsible lending practices were enforced, this may no longer be an option. Those in poverty would remain poor and social inequalities would be further established.

While a Labour Government's role is often assumed to include distribution of wealth within a society, at least to the extent of looking after those who are less well off, direct intervention by government to bailout all those struggling with financial distress, does not seem to be a sustainable solution.

Irresponsible Lending

Firstly, it would not be encouraging society to take personal responsibility for financial affairs if people knew that they would be bailed out should they experience problems. Also the costs for such an assistance scheme would escalate, as the number of people relying on Government help would increase. Secondly, benefits or credits are bound to be means-tested. Those from lower socio-economic classes, who are likely to experience financial problems, may be defeated by the complexity of completing application forms. They may also choose not to apply for Government assistance due to loss of personal pride. Such schemes therefore run the risk that well intended relief would not reach its target.

From a political perspective such a scheme is not likely to be a vote winner. Taxpayers are likely to question why they should foot the bill through taxes for avoidable financial distress. An alternative that would aid mobility within social classes and decrease the amount of financial distress experienced by the public is to pursue financial inclusion schemes for the deprived. Introducing comprehensive personal finance tuition in the early stages of education e.g. at GCSE level would improve overall financial literacy. Debt counselling services support the view that education should act as a solution to the problem at its source by introducing a fundamental change in consumer behaviour, rather than offering remedies after the damage has been done.

In addition to the social and economic aspects raised, Round also expressed that the RLI needs to be evaluated based on the practicality of implementing it. Although overall the response from both the Financial Institutions and the Consumer Organisations as stakeholders was that the RLI is a good idea in principle, they were concerned that it would be expensive, resource consuming, hard to define and difficult to implement. Many stakeholders also raised the question of the positioning of the RLI with regards to the other initiatives such as those initiated by the DTI, the BBA, the OFT, the Treasury Select Committee, the Basel Accreditation and the regular auditing by the FSA. The RLI would need to clearly differentiate itself as a standard that brings the other initiatives together if it were to be meaningful and worth the effort required to create it.

Many banks articulated concerns about how the RLI could turn into the “Irresponsible Lending

Index”. This would follow from intense competition between banks to achieve high scores. Evidently some will score higher than others. This may force some banks into action “to ensure they are not bottom of the pile”, but there was equally anxiety regarding the possible difficulty of raising a low score. Those who have scored worse than their competitors may attract media pressure and finger pointing, which may have undesired effects on a bank’s profitability. To add insult to injury, those who would be rated would have also contributed financially towards establishing the index. If an RLI standard were to be agreed, applying it consistently could also prove problematic. How should an organisation be ranked when it consists of a conglomerate of 8–10 separate divisions, which each have different processes and operations? Another point raised was that different lending institutions target different risk profiles, which will evidently be reflected in their processes and the resulting score.

The fundamental question of whose responsibility it is to ensure lending within limits remains unanswered. As a voluntary self-regulating index the RLI may not necessarily tackle the issue of those who are determined to pursue irresponsible borrowing practices a problem not just confined to the lenders. A report by uSwitch (2006) found that seven out of eight credit applicants were untruthful when stating their annual income details:

...applicants least likely to be truthful about their incomes are all from the most vulnerable groups, namely the self-employed, students, the unemployed, and those on low incomes (White, 2006, pp. 2–3).

There is a strong case for not limiting peoples’ access to credit and hence their mobility within a society and for not questioning their judgement as identified by the Crowther Committee in 1971. However, it seems that there is an even stronger case for enforcing responsible lending practices. The number of people facing financial distress is increasing as are the costs of writing off bad debts. Until financial literacy education has a significant impact on the behaviour of consumers, the banks are well advised to consider lending responsibly in order to protect their own reputation and the well being of their customers. Over the course of 9 months during

2005/2006 a series of meetings were held in which these issues were debated. It became clear that while the consumer bodies were prepared to look at the proposal in more detail, some banks and in particular the Banking Code Standards Board (BCSB), who saw the RLI as undermining their authority in the industry, vocally made their opposition known. With this resistance little progress was being made.

From the Responsible Lending Index to the responsible lending initiative

Round has summarised the outcome that “without a clear consensus on the definition of responsible lending, comparing them [lenders] would be at best difficult and at worst impossible”. The RLI in its original format failed to gain sufficient stakeholder support to be pursued further.

The original proposition may have seemed too revolutionary to many lenders. Hurlstons Consulting however recognised an opportunity and rather than pursuing a dead end, adjusted the idea to suit the current climate and the willingness of banks to take action on a smaller scale. The resulting proposition has been called the Responsible Lending Initiative (retaining the abbreviation RLI) and is concerned with developing a framework for responsible lending. Unlike the index, which would be an actual product, the initiative would be a forum for stakeholder engagement. This would be possible through stakeholders contributing to discussion, sharing current procedures on best practice and commissioning academic research into areas raised by stakeholders. The differentiating factors between the revised initiative and other initiatives currently in the industry are that the Responsible Lending Initiative would still be grounded in stakeholder engagement and monitoring by having consumer organisations involved in it and that it would aim to be transparent (most other initiatives are “closed shops” to consumers and the media).

The industry regulators such as the British Bankers' Association (BBA) and the Banking Code Standards Board (BCSB) were not very supportive of the original RLI concept, questioning the need for an additional standard to be introduced into the industry. It seemed that they feared their authority was being undermined or bypassed by the RLI. Consumer organizations openly pledged their sup-

port for the initiative and some of the banks consulted appear to be showing an interest. John McFall, MP, Chairman of the Treasury Select Committee, commented at a public meeting on the RLI on the 26th of October 2005 that the initiative sounds good, but whatever the outcome, the industry should not lose sight of striving towards best practice and data sharing.

Round used several tools to advance the agenda of the RLI. Firstly, setting a deadline for pledges of support was crucial in ensuring momentum. The timing was also critical in terms of publicity—post-Christmas news headlines often display stories of over spending on credit cards and the rising debt mountain. The RLI would have given banks an opportunity to respond to the negative publicity. Secondly, inviting McFall to address the public meeting on the RLI also sent signals that the initiative should be taken seriously. Round subsequently used McFall to provide leverage in negotiations, referring to the “worst possible outcome” whereby the Treasury Select Committee could pursue legislation because the banks have not been willing to take part in an initiative such as the RLI. In this case Round was drawing on the perception that self-regulation was preferable to imposed controls (Kaye, 2003).

During the process, Round moved from purely lobbying for support into the role of a negotiator. The initial RLI proposal proved unachievable because Round, the consumer organisations and the banks held different positions. Round wanted to establish an index and the banks wanted to protect their brand. To gain support for the revised RLI Round focused on the other stakeholders and their interests and how they could be reconciled with the banks. Round kept the banks involved as it was in the banks' interest to continue discussion on responsible lending practices, as participation in any initiative will promote their brand and may ease the pressure from the legislative bodies. Round's interest lay with helping banks promote themselves in terms of their achievements and protecting themselves from cumbersome legislation. Ultimately banks need a mechanism to address the fear that accusations of irresponsible lending would damage profits, and Round needed their support to successfully launch the RLI.

The new Responsible Lending Initiative proposition seemed to be gaining sufficient support with

the Chairmen of two major banks indicating they would financially support a pilot study. It also offered considerable academic research possibilities from evaluation of the initiative and broadening the scope of the study to cover experiences in continental Europe and the U.S. Consumer behaviour, financial literacy, the impact of education and the moral question of whose responsibility it is to ensure borrowing were also possible further research subjects. However, this was not to be as on the 3rd of April 2006 Round received a letter from APACS effectively killing the initiative by saying that members collectively had a lack of general interest.

Observations and conclusion

This case study has provided a practice-based case reflecting a current social and credit industry issue, to be added to the growing interest in stakeholder democracy and a context for business ethics literature. In essence, the Responsible Lending Index (RLI) was welcomed as a good idea by most stakeholders but failed to gain sufficient support to be pursued further in its original format. The reasons for this are examined here in the context of stakeholder and ethics discourse.

It can be argued that the main reason for the failure of the RLI was that the banks feared the repercussions of any negative rating and in particular adverse effects on their brand. The initiative was effectively stopped by APACS because it was perceived as being "...unnecessary duplication of work and effort"². The APACS letter went on to justify this conclusion by making reference to:

- sharing best practice through trade journals;
- extensive research already commissioned on the U.K. credit market;
- extensive lobbying already in existence, public relation initiatives; and
- the industry was already at the forefront of responsible lending.

Perhaps, the confidence of APACS to turn down the initiative was also supported by the current U.K. Government response to the European Consumer Credit Directive, where its opinion included the

proposition to "...remove the concept of responsible lending" in the context of ensuring there are enough adequate provisions on information and licensing (DTI, 2005, p. 7). In essence then APACS remained within the traditional confines of corporate engagement and views on codes of ethics outlined by Brinkmann and Ims (2003) and as identified in the Code of Banking Practice (Cowton, 2002). The literature on ethical banking is set within a paradigm of thinking which argues that as an institution banks in principle have a higher duty to consumers (George, 1992; Green, 1989). However, the credit card lenders would seem to have remained somewhat distant from this lofty aim, perhaps due to the nature of their customer relations. In contrast to the more direct and personal relationship between the bank and the customer, it can be argued that the credit sub-sector is more profit-driven and less absorbed in ensuring responsibility to its customers.

Was there a lack of leadership by the banks and their respective trade bodies, particularly within APACS? As evidenced by the numerous affinity charity and trade union cards and the more recent American Express Red, the credit service industry is not slow to embrace market-lead social initiatives when they are profitable, but equally, in such initiatives the involvement of stakeholders takes place at the periphery. When it comes to governance however, the RLI case study illustrates a different story.

It is important to question why some banks did not break away and support the RLI even though it failed to gather industry-wide support. Round believes it is simply not in the nature of banks to break away. While the Royal Bank of Scotland showed the greatest interest and thought it was a good idea, they believed it was too difficult to implement and a matter of significant resources and time. Due to a lack of support from key decision makers, the RLI concept was not sufficiently compelling for some banks to break away and/or move the BBA and APACS to endorse the initiative.

In contrast to this attribution to the power of persuasive leaders, behaviour is also explored within the literature on stakeholders and their collective action to influence their environment. For example, the work of Munshi (2006) in the context of the Scotch whisky industry provides a social constructionist perspective which helps shed light on

stakeholder group action in an industry context. The author argues that industries are not “merely clusters of competing firms, but social and cognitive systems in their own right” (Munshi, 2006, p. 4). Such an approach to stakeholder behaviour argues that stakeholders are most likely to take collective action when they are both protecting their interest and are bounded by their shared identity, based on group membership (Rowley and Moldoveanu, 2003). In a similar theme explored by Munshi (2006) on the Scotch whisky industry, the group collectively forced one major manufacturer to withdraw its product. As Munshi observes,

[t]hese socially constructed representations in industries takes the form of shared narratives and beliefs with which stakeholders of the industry can collectively and individually identify. Thus, changes that are perceived as being radically different from those shared mental models will increase the chances of industry level collective stakeholder action (p.14)

Reflecting on the RLI case, it follow analogically that the credit industry collectively resists this attempt for a consolidated reform in a responsible lending direction, led by their individual motivations to remain competitive in the market. Munshi’s work refers to the Tragedy of the Commons, which holds that “stakeholders will forsake their long-term collective benefits for their immediate short-term economic self-interests” and argues that the opposite is visible in her case study (p.14). In the case of the RLI, it is the collective resistance which is driven by short-term self-interest, which is yet another way of looking at and confirming the Tragedy of the Commons. Seen from this perspective, the concept of “stakeholder participation” as it represents the role of consumers in responsible credit practices is an oxymoron, since it is only a representation of this collective resistance.

Outside the stakeholder discourse, the development of RLI reflects a number of issues raised by the business ethics literature as it relates to the banking industry practices. For example, Keep’s (2003) work on economic motivations to sustain the practice of business lies can be evidenced in the desire of credit card suppliers to keep the real costs of borrowing a secret. The current disclosure of estimated interest cost for the month, now

disclosed on credit card bills, looks transparently attractive but fails to explain the real cost when applied on a continuous basis. The reward and commissioning structure for credit staff is never revealed. Therefore the complex issues of ethical decision-making identified by Beu et al. (2003) would suggest that credit staff could be inclined to encourage extended borrowing as their own jobs and performance related pay may depend on encouraging borrowing.

Offering credit to all is justified by the credit industry by claims of widening people’s social choices, but can this be justified against the human misery seen by the credit counselling services, which can lead to suicide? For example, the selling of a drink to an alcoholic would be viewed as unethical and be roundly condemned. Is not constantly extending credit to someone who eventually is unable to pay equally unjustified? Finally, in regards to socially responsible lending, the claim by APACS that “the industry considers itself to be operating to very high standards of responsible lending” is unsustainable (APACS, 2006).

The problem of financial distress among consumers is growing and cannot be ignored—left to market forces it is likely that sustained media pressure will eventually force a government to introduce a lending code backed by statutory regulation. In this scenario the advent of such regulation may well see no winners. Those currently able to access lending may well find themselves denied credit under a statutory code, while the costs of such regulation will have to be met by the banks and so ultimately, by the customer.

In conclusion, although the full RLI concept can be argued to have been too radical and ahead of its time, some of its underlying ideas have appeared in other accepted forms, for example, bank credit data-sharing and cost of borrowing (Henderson, 2006). Thus, given the unresolved rising debt in the U.K. and the current harmonisation and responsibility practices, an RLI-based initiative which is both proactive and reactive to the development of the credit sector may still have a future in some revised format. However, it is likely that it is grounded in conventional banking practice rather than in the stakeholder engagement perspective of the original RLI.

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Notes

¹ Interview with Round

² Letter to Steve Round, 3 April 2006 personal communication

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